BUSINESS IN BRIEF

monthly by the Economic Resea
MANHATTAN BANK
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The business recovery is vigorous and broadly-based. Industrial production is up 10% in six months, more than making up for the 8% decline during the recession. All but 5 of the 28 industries in the Index have shared in the advance. Experience shows that a recovery which extends across a wide front in its early stages usually presages an extended period of good business.

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However, the business mood could hardly be described as one of aggressive optimism. Statistics on new orders, capital appropriations and expenditure plans, and inventory buying anticipations reveal a certain hesitation, a cautious mood with respect to forward commitments.

This attitude is partly explained by the fact that the business upswing is still in an early stage. Productive capacity appears ample. And corporate earnings, while up from their recession lows, are still below satisfactory levels. A continuation of the business recovery could improve the earnings picture and lead to increases in capital expenditure programs.

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Nevertheless, many businessmen are concerned over a series of developments which appear to becloud the atmosphere.

¶ International tensions necessarily color forward planning. Discussions of further defense moves, which might lead to increased taxes and direct controls, are unsettling.

¶ Increases in government spending, over and above those required for national security, add to concern over the possibility of inflation.

¶ Trends in U. S. foreign trade raise questions about the future balance of payments position, which could be complicated by any domestic inflation.

Consequently, the fact that the business mood is one of caution is not surprising. To the extent that it marks a realistic appraisal of the future, such caution can be constructive. In these uncertain times, business plans must be based on a hard look at the future, and attuned flexibly to the demands of intense competition.

Excess capacity may turn out to be much less of a drag on business capital investment than is generally believed. Expenditures to expand capacity were cut back sharply in 1958, and have remained relatively low ever since. As a result, the nation's over-all capacity to produce goods and services has grown only 7% since 1957. In contrast, constant dollar GNP in the second quarter of this year was 9% above 1957.

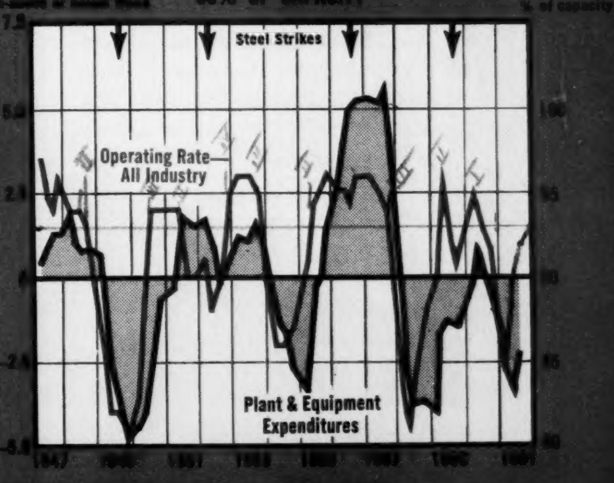
The same picture shows up in the industrial sector. Production is 12% above the 1957 level, while estimates show that capacity is only 8% greater. Industry as a whole operated at 90% of capacity in the second quarter.

If production should expand during the next year in line with the average recovery pattern of the postwar period, an advance of about 10% could be registered. Even with some further growth in capacity, such an advance would lift operating rates in many industries to high levels, paving the way for a new expansion.

Corporate earnings would have to increase to provide the incentives for a new wave of expansion. Earnings after taxes in relation to both GNP and invested capital were on a declining trend in the 1955-60 period. However, preliminary estimates suggest that a sharp improvement took place in the second quarter.

A continued rise in earnings would be necessary to restore an average rate of return on invested capital which would spur economic growth. Thus, the nation's chances of achieving a full recovery depend importantly on efforts to hold costs in line and make the period ahead one of reasonably profitable prosperity.

CAPITAL INVESTMENT RISES WHEN OUTPUT MOVES ABOVE 90% OF CAPACITY



Data: University of Pennsylvania; U.S. Dept. of Commerce, SEC

CONSUMER SPENDING FOR SERVICES

Are we living in an economy dominated by services? Casual observation of the U. S. scene in recent years would suggest that we are. The fastest growing lines seem to be services of one sort or another, and here is where job openings have been expanding.

Yet when one looks at the facts, it is clear that services, while of growing importance, are far from dominant. Consumer outlays for all services will pass the $140 billion mark this year. That's a bit more than one-fourth of GNP and about 40% of all consumer purchases. At the end of World War II, less than one-third of consumer expenditures went for services. However, the current ratio is back to that of the late-1920's. So part of the recent rise represents a catching-up process.

Three Questions

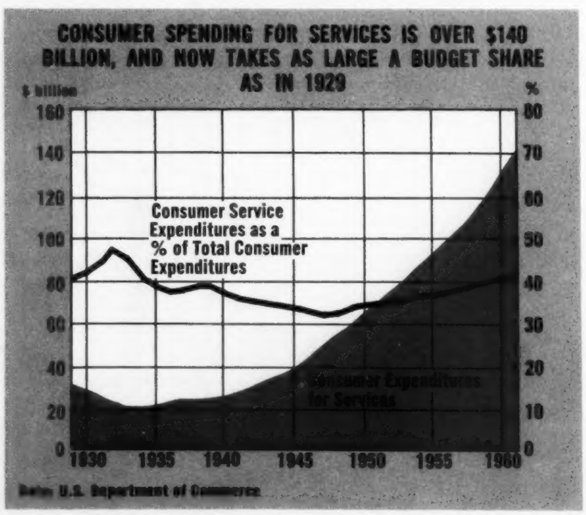
Nevertheless, the growth of services, particularly in the past five years, has directed attention to three important questions:

- Do efforts devoted to production of services contribute as much to well-being as is the case with goods? Should services therefore be counted alike with goods in measuring the economy's total output?

- If more is spent for services and for food and other nondurables, will people have enough money left over to support expanding markets for autos and other durable goods?

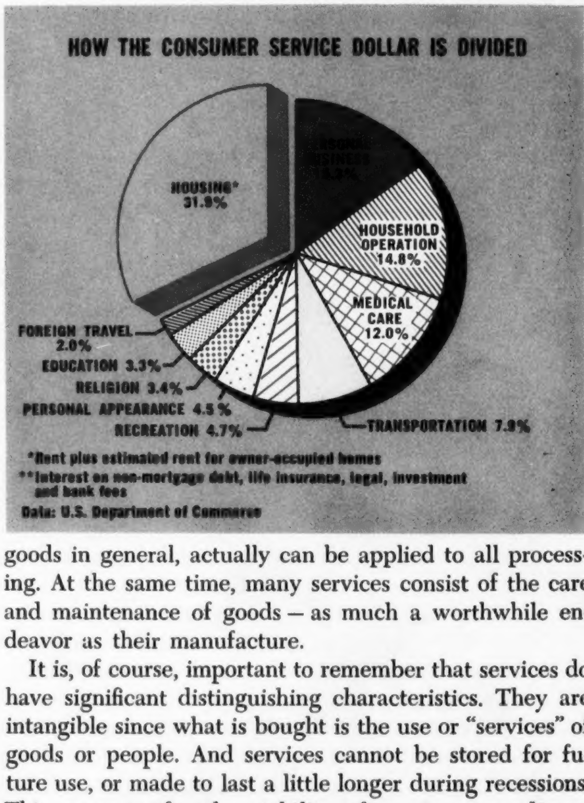
- Will the emphasis on services act as an impetus to inflation and a drag on real economic growth? This concern arises because service prices have increased more rapidly than goods prices in recent years while efficiency in the service sector has not improved as much as in the economy as a whole.

The question as to whether services should be counted on a par with goods has a long history. It harks back to discussions by 18th century economists of the distinction between productive and non-productive labor. This controversy was finally resolved by an agreement to refer the decision to the market – if the market valued two types of labor equally, they were regarded as making an equal contribution to general well-being.



The same general approach applies to services. If the market values a given service at $1.00, it is as much of an addition to the output of the nation as the production of a good which sells for $1.00. Thus, the market value of services is counted as part of gross national product.

The case for counting services on a par with goods is buttressed by the fact that it is difficult to make a clear cut distinction between them. The phrase "built-in-service", often applied to goods such as TV dinners and sometimes to the packaging and distribution of goods in general, actually can be applied to all processing. At the same time, many services consist of the care and maintenance of goods – as much a worthwhile endeavor as their manufacture.



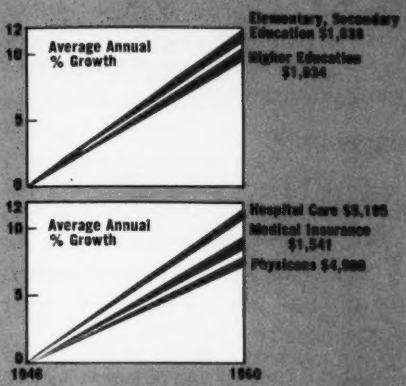
It is, of course, important to remember that services do have significant distinguishing characteristics. They are intangible since what is bought is the use or "services" of goods or people. And services cannot be stored for future use, or made to last a little longer during recessions. This accounts for the stability of service expenditures when incomes decline.

Services in the Family Budget

What services do consumers buy? Housing is the largest item classified as a service expenditure in the official statistics of the U. S. Department of Commerce. Last year's expenditures for housing were estimated at $42 billion, or nearly one-third of consumer service outlays. This includes rent actually paid plus "imputed rent"– a technical term for an estimate of what consumers would have to pay if they rented their homes.

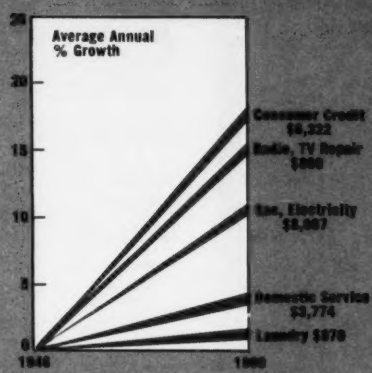
The procedure of estimating imputed rent has been subject to criticism as introducing a purely hypothetical

CONSUMER OUTLAYS FOR EDUCATION AND MEDICAL CARE ARE FAST-GROWING

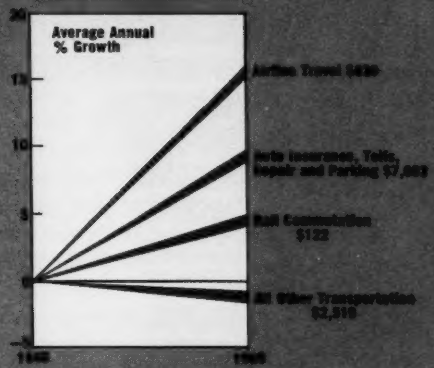


THE RISING STOCK OF DURABLES HELPED SOME SERVICES, HURT OTHERS

(Dollar figures in millions)



AUTO OWNERSHIP HAS TRANSFORMED TRAVEL



Data: U.S. Department of Commerce

element in the national accounts. However, it replaces a series of difficult-to-estimate items including property taxes, mortgage payments, maintenance, repair and other costs of home ownership. So most of imputed rent represents actual outlays by home owners. This is important since three-fifths of all families now own their homes.

Of the remaining categories, what the Commerce Department terms "personal business" bulks largest. It totaled $20.6 billion last year including interest paid on non-mortgage debt, life insurance, legal, investment and bank fees. Household operation (electricity, telephone, gas and water charges plus domestic service and miscellaneous expenses) took $19.6 billion more. Next in size was medical service for which $16.2 billion was paid, and then came transportation service which took $10.5 billion. Finally, there were several smaller categories: recreation ($6.4 billion), personal appearance ($6.1), religion and welfare ($4.7), private education ($4.5), and foreign travel ($2.6 billion).

Services That Grew

Most interesting is a study of which services have grown fastest and why. Over the postwar period:

Personal business was the most rapidly growing category. Behind its rise was the large increase in consumer assets, and the greater use of consumer credit. Of all single items, interest on non-mortgage debt went up most. This was due to the mounting expenditures on consumer durables, the shift in attitudes toward considering debt repayment a form of regular saving, and the recovery of interest rates from their wartime low.

Private education expenditures have expanded second most rapidly over the postwar period, and most rapidly in recent years. Both outlays for private elementary and secondary schools and those for higher education have been on the list of the ten items which have increased most since 1946. The rise in the number of school-age children, the greater importance placed on education by more highly educated parents, the current needs of business and the greater ability to finance education all contributed to the rise in spending.

Foreign travel had the third highest rate of advance. This is one of the outlays which increases more than in proportion to the rise in income. However, immediately after World War II travel abroad was abnormally low so the increase since then has been greater than usual.

Medical service was fourth among growing categories. Outlays for hospital care went up most, followed by payments for medical insurance. Although medical care is often considered a necessity, it is clear that as income rises people are willing to spend more for medical care.

Household operation payments have also expanded — principally as a result of the greater use of utilities with the growing stock of appliances.

Religious and welfare expenditures, too, have grown faster than the average consumer outlay.

The other three major categories of service outlays have taken declining shares of the consumer budget. But within each category, striking differences appear.

Within **transportation,** airline travel, automobile insurance and road tolls are on the list of the top ten growth items. Suburban living and increasing incomes have led to the use of automobiles and rail commutation for local travel and airplanes for longer trips. Other forms of local and intercity transport have declined.

Among **recreation** services, radio and TV repair is in the top ten due to the rise in TV ownership to 90% of all families. Admissions, particularly to movies, on the contrary have declined compared with 1946.

In the **personal appearance** category, beauty and barber shop outlays have had average growth, but laundry, clothing and shoe cleaning and repair have risen slowly, replaced by easy-care fabrics and home washers.

Services vs. Durable Goods

This analysis of specific service outlays shows that, while many factors were behind the rapid growth of services, two provided much of the explanation.

First was the growth and changing distribution of income. This is true because several categories of service

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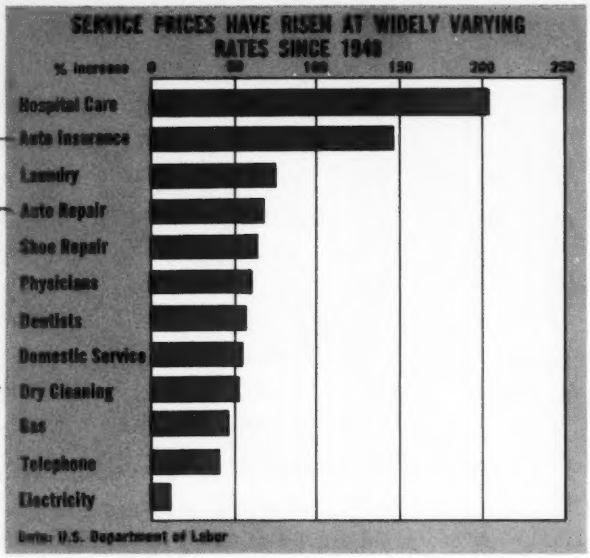


expenditure – education, medical care and household operation among them – increase more than in proportion to the rise in income, especially between low and middle income brackets. Also, higher incomes permitted the build-up of financial assets – now 2½ times larger than in 1946 – which generated demand for bank services, investment and legal advice.

Second was the increase in the stock of durable goods. Of the ten fastest growing service items, demand for five was generated by this expanded stock, and all service outlays related to the financing, insurance, operation and maintenance of durables now take a larger share of consumer budgets.

Thus, it is clear that the relationship between services and durable goods is not simply one of competition by services for consumer dollars which might otherwise go for the purchase of durables. Some services must grow along with the stock of durables. In other cases, the purchase of durables – automobiles, TV sets, washing machines and other appliances – has reduced the market for certain services. This is shown by the declining importance of intercity rail and bus transportation and domestic service workers.

However, some services do compete for the consumer dollar at the expense of durables. The two most important of these are education and medical care. The increased proportion of the population in the college and over 65 age groups, technological progress, and new methods of finance seem to indicate that these services will continue to grow fast, taking perhaps 9% of income by 1970 vs. 6% now.

Total service outlays will not increase as much as these two, but they seem to maintain a steady and relatively rapid growth. Whether this means that services will take a larger share of consumer budgets seems to depend heavily on the rate of growth of the economy.

In the past, whenever the economy went through a period of slack or slow growth, services took a larger share of consumer income. Whenever the economy grew rapidly, sales of durable goods increased, and services were held to a nearly constant share of income. Potential demand for durables will be high in the years ahead. Therefore, a good rate of economic growth plus attractive products could prevent the steady growth of services from cutting into the market for durables.

Inflation and Productivity

Now let's turn to the third question: Is the growth of services an impetus to inflation and a drag on real economic growth? Here is the evidence since 1946.

- Service prices have risen at widely varying rates. The price of electricity rose only 11% over the 14 years while that of hospital rooms went up 205%.

- Statistics show that the average rise in service prices was about 65% compared with 52% for consumer prices as a whole.

- However, experts have questioned whether the difference between service and other prices is not exaggerated by these price indices. An effort is made to eliminate some of the price rises associated with quality improvement. For example, a new-model appliance is linked into the index so that the extra expense of improved features is not counted. But in the case of services, quality-associated price rise is very difficult to eliminate. For instance, better care has accompanied higher hospital charges, but no account has been made in price indices for this.

A related question is whether the advance in service efficiency has been as rapid as that of goods producers.

- Here again there is wide variety. Productivity in the utility and telephone industries has improved more than in any other sector except agriculture. But in other services efficiency has advanced slowly.

- Output per manhour in all goods-producing industries combined has increased 4.4% per year. The exclusion of agriculture would bring this rate down to 3.1%. The corresponding figure for services is 2.8%.

- Since these statistics are made using constant dollar expenditures as a measure of output, they are subject to understatement. Quality improvements, which are a type of increase in output, are eliminated to the extent that they are associated with price rises.

This review leads to the conclusion that the price increase of services has been somewhat overstated both absolutely and relative to other price increases, and that productivity in services has not improved so slowly as to place an appreciable drag on real economic growth.

Thus, it is clear that the output of services has proven a valuable addition to the nation's production. Continued efforts are necessary to increase efficiency, mobility and skill in order to adapt to the changing demand. Nevertheless, the increased importance of services in our economy need not result in smaller markets for automobiles and other consumer durable goods or in higher prices and slower economic growth.

BUSINESS RECOVERY AND THE COMMERCIAL BANKS

Will commercial banks be able to meet the loan demands generated by a sustained advance in business activity? The current upturn in spending for inventories and plant and equipment – the type of outlay often financed by borrowed funds – makes this a timely question. The answer turns partly on the existing state of bank liquidity. But over the longer run, the policies of the monetary authorities are likely to be a more potent influence on bank lending than at any time during the postwar period.

Recent Developments

The current surge in business has not yet been accompanied by an appreciable increase in bank lending. This is not unusual during the early stages of a recovery period. Typically, capital outlays have remained near their recession lows, and rebuilding of inventories has so far been modest. Moreover, the record volume of financing in the capital markets during the spring and larger retained earnings have provided enough funds to cover the immediate needs of most businesses.

Banks have taken advantage of this lull in loan demands to improve further their liquidity positions, a process that began during the recession period.

- Loan/net deposit ratios of the larger reporting banks about the country have been reduced from a postwar peak of about 65½% in June 1960 to 61% today.
- Holdings of short-term Government securities of these leading banks have been increased by $8.7 billion over the past year, and almost one-half billion dollars was added to their holdings of bankers' acceptances.

As a result, banks are now in a position, should the need arise, to shift a sizeable volume of their existing assets to loans smoothly and quickly. In fact, holdings of very short-term securities, relative to total assets, are now the largest since the mid-1950s.

Restraining Influences

Nevertheless, the capacity of banks for meeting a sustained increase in loan demands from existing resources is much less ample than during past periods of business recovery. For one thing, loan/deposit ratios, while down significantly from the 1960 peak, are still relatively high by earlier standards. And the build-up in holdings of short-term securities has been partly at the expense of intermediate and longer issues – the sort of asset that provides "second-line" liquidity.

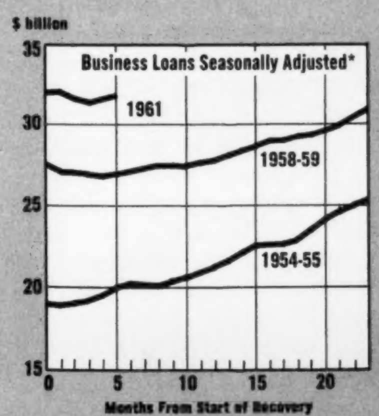
Moreover, the improvements in liquidity over the past year have been made possible largely by a record $10.5 billion increase in savings and time deposits. Experience shows that certain deposits of this sort are vulnerable to withdrawal as business activity expands and competitive interest rates rise. This is particularly true so long as commercial banks are prohibited by regulation from paying more than 3% for these funds. The implication is that banks cannot safely count on this uptrend continuing in the months ahead.

Federal Reserve Policy

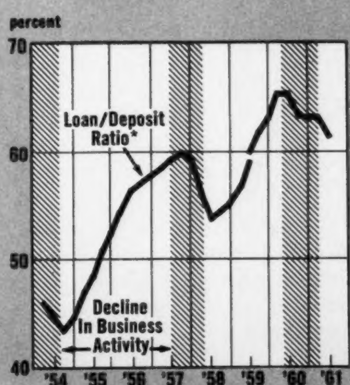
Under these circumstances, Federal Reserve policy – as expressed both in the level of short-term market rates and the growth of the money supply – will become critically important as the business expansion is prolonged, even more so than in earlier prosperous years. In 1956-57 and 1959, for instance, commercial banks were able to increase their loans substantially even though highly restrictive monetary policies held the money supply (and demand deposits) virtually unchanged. Similar policies today, however, might rather quickly impede the ability of banks to meet the legitimate credit needs of business.

The authorities are clearly alert to this possibility. Thus, relatively "easy money" policies have been continued longer than during the similar recovery period of 1958. Until the current expansion reaches a point where inflationary pressures become more clearly evident, this caution in turning toward restraint appears justified in the interest of facilitating fuller use of the nation's physical and human resources.

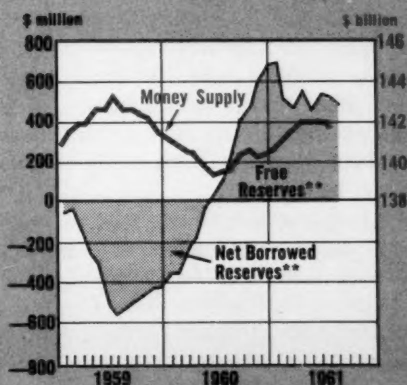
COMMERCIAL LOANS USUALLY TURN UP SEVERAL MONTHS AFTER RECOVERY STARTS



BANKS HAVE IMPROVED LIQUIDITY POSITIONS SOMEWHAT



FEDERAL RESERVE CONTINUES TO SUPPLY RESERVES LIBERALLY



*All Weekly Reporting Banks
**All Member Banks

Data: Board of Governors, Federal Reserve System

U. S. BALANCE OF PAYMENTS OUTLOOK

Substantial improvement characterized the U. S. balance of international payments during the first half of this year. Exports remained at high levels, with imports below last year's average, so the trade surplus – about $5.3 billion at annual rates – was ample to cover most other U. S. commitments abroad. Also, the heavy outflow of short-term capital that began in mid-1960 came to a halt by May of this year, thus relieving pressure from this source. In addition, some $650 million in advance repayments of loans came from Germany, Holland and the Philippines in the second quarter.

As a result of these factors, and despite a 6% drop in exports in the April-June period, preliminary estimates show an over-all deficit in the first six months of 1961 of only about $100 million at annual rates. This compares with an average of nearly $4 billion during the previous three years. The question now is whether this recent progress in bringing our international accounts into balance will be maintained.

Business Cycle Effects

The most decisive factor in the improvement in the U. S. balance of payments during the past two years has been the growing surplus on current account. And this surplus can be traced in part to the slower rate of economic advance in this country relative to Europe and Japan. U. S. imports normally pick up about the time U. S. business conditions begin to recover from a recession. However, they tend to taper off before the peak of the business cycle and to hold even or decline until after the new upturn.

Thus, in the first quarter of 1958, imports began rising at the business upturn. They reached a peak in the third quarter of 1959, almost a year before general business activity, and tended downward until the second quarter of this year. The recent business upturn beginning around February has resulted in a turn-around in imports – which were up 2% in the second quarter.

Exports have tended to respond strongly to change in the intensity of economic activity in Europe, Japan and Canada – which take almost two-thirds of our foreign shipments. For instance, the sharp pick-up in U. S. exports starting in the first quarter of 1959 came only a few months after the pick-up in business activity in Europe and Japan. Both U. S. exports and industrial activity in those countries rose very rapidly for over a year. But after the second quarter 1960, both began to grow at a slower pace. By the second quarter of 1961, industrial expansion abroad continued upward, though in a somewhat more leisurely fashion, while U. S. exports actually declined by 6%.

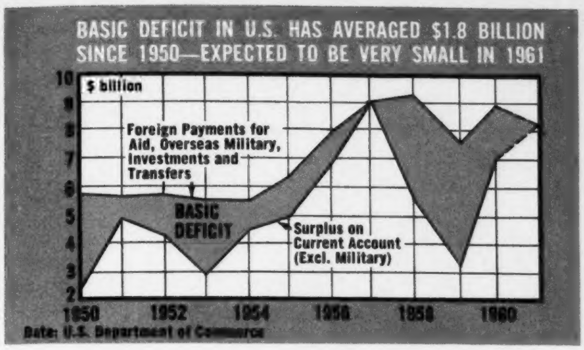
The U. S. is now well into a broad economic recovery, so imports are most likely to continue upward. Purchases of foreign aircraft in the second half of the year are estimated at $100 million above the first half; auto imports are expected to rise, as sales are running ahead of imports; steel purchases have already started up, and are likely to continue; and natural rubber imports are due to expand with the anticipated rise in auto sales.

Meanwhile, exports may have reached their peak for this year in the first quarter. Although cotton sales are expected to advance sharply in the second half, the sort of vigorous expansion which came last year from aircraft sales, heavy machinery – indeed from most major export categories – does not seem likely in the near future. Hence, by the end of 1961 the U. S. trade surplus could be well below the $6.9 billion rate reached in the first quarter. What this means for the longer run can be seen best in the light of the over-all balance of payments position of the United States.

The Basic Deficit Has Narrowed

A useful simplification of the very complex balance of payments statement is to add up the nation's commitments for overseas expenditures (foreign aid, military expenditures, long-term investments, pensions and other transfers) and match these against the current account balance (the net receipts or net payments due to normal transactions in goods and services, excluding military expenditures abroad). The difference between these two accounts has been called the "basic deficit". In a rough way it can be thought of as the amount by which the current account surplus is inadequate to meet commitments for foreign aid, military expenditures, long-term investments, etc. This deficit, plus unrecorded transactions and flows of short-term U. S. capital, constitutes the over-all deficit as usually defined.

Looking back over the years since 1950, the U. S. has consistently run a sizeable surplus *on current account* – never falling below $2.3 billion, and rising to about $9 billion in 1957. However, foreign aid, military and other commitments have generally been much higher, so the *basic deficit* has been substantial – averaging nearly $1.8 billion for the past eleven years. In only one of the years



between 1950 and 1961 was the deficit less than $100 million, and that was in 1957 – the year of Suez which climaxed a period of intense investment activity throughout the world.

It now looks as though 1961 will be another year with little or no basic deficit. In the past two years, the current account surplus has grown very rapidly at the same time the other commitments have tended to stabilize.

Non-Trade Commitments Rise

If these trends were to continue, within a few years the U. S. would have a basic surplus. However, it seems most unlikely that the major commitments will remain at their present level. The question is whether the current account surplus will rise fast enough over the years to meet them. This is basically a question of what our export performance must be during coming years. One way to approach an answer is to consider a projection of trends in our non-trade commitments as they now appear to shape up through, say, 1970, and then match this against a projection of our surplus on current account.

Viewing our commitments conservatively over the next decade, it seems reasonable to estimate their average rise at between 3 and 4% a year. Actually, foreign aid is likely to rise more rapidly – at perhaps 5% a year. This is about the rate of increase in the past five years, if military grants, which have been falling, are excluded. And there is no visible let-up in the rate at which such funds are being committed. Foreign investments, which had risen very rapidly over the past decade, have moved down in the last few years. U. S. investment in Latin America and Canada seems likely to grow slowly in the future, though European investment may continue to accelerate.

On balance, private investment seems unlikely to grow more than 5 or 6% a year, perhaps less. Military expenditures, which rose very rapidly after 1950, the year of the Korean crisis, have fallen from their peak of $3.4 billion in 1958 to about $3 billion in 1960 and 1961. It is difficult to project these figures, but the Administration will probably try to continue to keep dollar expenditures at or below the present level so long as this can be done without harm to our defense posture.

Adding up all these trends would give a projected payments commitment of something over $11 billion in 1970 – compared to $8.2 billion in 1961. The average over the next nine years would amount to about $9½ billion.

Trade Trends

Looking next at trends in trade, both exports and imports have risen since 1950 at an average rate of 5% a year. If, starting at this year's level, they both continued to rise at this rate, by 1970 we would have a current account surplus of over $13 billion – more than enough to satisfy projected commitments. In the short run, however, imports are due to rise more rapidly for at least a year, and exports will do well to hold even during the same period. Thus, it seems probable that we may have another basic deficit in 1962, though it need not be large. In order to make up for this and maintain an adequate surplus on current account over the coming years, exports will have to expand vigorously – they will have to move up to an average annual growth trend of nearly 5% and maintain that pace. This means that U. S. exporters must be competitive in world markets.

Thus it is encouraging that the U. S. export business seems more vigorous today than ever before – despite the fact that in the past three years foreign competition has also become more intense. As a result, U. S. companies are taking a closer measure of their world trade adversaries, trying to come up with better and cheaper products more adapted to foreign markets, strengthening their foreign sales departments, and selling harder domestically against foreign imports. U. S. exporters of industrial chemicals, computers and office equipment, and manufactured food have moved ahead sharply despite heavy world competition.

Another encouraging sign related to our imports is that several important sectors of U. S. business have seized the initiative, without benefit of protective tariffs, to regain markets being invaded by foreign producers. The automobile market is the most important example.

Nevertheless, this country needs a large and expanding flow of imports – goods that we don't produce, or produce too expensively. This is one of the legs on which our economy stands. At the same time U. S. industry has a wide range of products needed abroad, which cannot be produced as well or in sufficient quantity by foreign sources. It is vitally important to us, as well as to the rest of the Free World, that our exports expand at a rate sufficient to maintain balance in our over-all payments position.

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